



Final Minutes
Endowment Fund Investment Board Special Meeting
August 2, 2005

A special meeting of the Endowment Fund Investment Board (Board) was held in the Board Conference Room at 816 W. Bannock Street, Ste. 301, Boise Idaho on August 2, 2005. Chairman M. Dean Buffington called the meeting to order at 2:06 p.m. and recognized that a quorum was present.

Members Present:

M. Dean Buffington

Members by Teleconference:

Representative Bill Deal

Vaughn Heinrich

Tom Kealey

Senator Brad Little

John Taylor

Parker Woodall

Members Absent:

Gavin Gee

Bill Mitchell

Staff Present:

Richelle Sugiyama

Andy Potter

Judy Shock

Guests:

Bobby Lawrence, Eide Bailly

Julie Weaver, Deputy Attorney General

Bob Maynard, PERSI

Steve Allison, SCO

Opening Comments

Chairman Buffington proposed that for this meeting and all future Endowment Fund Investment Board meetings, Julie Weaver, Deputy Attorney General, be invited to attend all board meetings as our legal counsel.

Chairman Buffington also requested that draft minutes of the meetings be distributed to the Board for review as soon as possible.

1. FY 2004 Gain Allocation Calculation

Ms. Sugiyama indicated that there may be some interpretation problems with the inflation adjustment to the gain benchmark calculation and if a determination is made that changes to the statutes are necessary, we may need to discuss this further and ask for Senator Little's assistance in moving this forward.

2. Reallocation of Gains

This issue is related to spending policy: In 2004, EFIB calculated the gains (investment change in market value or unrealized/realized gains and losses), and attributed 100% of this gain to the permanent fund. The statute indicates that before you come to the determination of whether or not there is a statutory gain or loss, the gains should be allocated proportionately to the permanent fund and earnings reserve balances. Instead, the statute may have been misinterpreted and 100% of investment gains were posted to the permanent fund. What should have been done was to look at the unrealized and realized gains and losses and attribute that in proportion to the permanent fund and the earnings reserve balances.

The impact? The Land Board has the discretion to transfer funds from earnings reserve to permanent. The way the gains were allocated in 2004 basically took the decision away from the Land Board by allocating all of the gain to permanent, and did not allocate it proportionately to earnings reserve and the permanent fund. Ms. Sugiyama consulted with Bobby (Eide Bailly), Steve Allison (SCO), Andy, and Kent Nelson and Julie Weaver (Attorney General's office). Everyone reviewed the statute and agreed that yes, this should have been allocated proportionately.

The EFIB needs to provide our recommendation to Land Board; but leave the decision to Land Board. Chairman Buffington indicated that the Governor made it clear that it is the Land Board's decision to make policy. The EFIB reports to the Land Board and any policy actions would be in the form of a recommendation. Representative Deal agreed that EFIB reports to the Land Board.

Representative Deal continued with questions regarding the revenue stream to the earnings reserve versus the permanent fund. He continued that his thought, and perhaps the thought behind this gain allocation, was that because this was money flowing in and out of the accounts, that they technically don't earn any, or as much in gains, and therefore all of the gain should go the permanent fund.

Ms. Sugiyama indicated that by restating 2004, the permanent fund balances will decrease and the earnings reserve balances (with the exception of Agricultural College and Charitable – these are running negative or zero balances) will increase.

Ms. Sugiyama said that today Bobby Lawrence (Eide Bailly) and Julie Weaver (AG) assisted EFIB Staff in calculating and reviewing the numbers to ensure the proper interpretation and implementation of the statute.

As stated before, the primary revenue stream of the earnings reserve account is the Lands revenue. If the revenue and expense projections do not come true, one might be digging into the earnings reserve balances. This could make a difference for some of the underlying beneficiary accounts. Mr. Woodall asked if we make the switch back – would this help the two funds which are underwater. Bobby Lawrence answered that it would not because these have negative balances in the earnings reserve and you therefore cannot allocate a gain. All of these would go to the permanent fund. Mr. Woodall asked if their part of the gain would be greater. Mr. Lawrence responded that nothing really changes, but remain in the permanent fund where it was originally posted (it can't be allocated down). The change is the allocation between permanent and earnings reserve. Mr. Lawrence reiterated that Mr. Haertzen had made the decision to allocate 100% to that fund and it as within what the EFIB could do. Ms. Sugiyama clarified that the Land Board has the discretion to change, not the EFIB. Chairman Buffington asked if this situation only happened this one year. Ms. Sugiyama responded yes. Mr. Lawrence added that previously, it was allocated monthly and Deloitte had done a prior period adjustment to change it to an annual allocation in accordance with that, and the next year Eide Bailly came on and didn't have the history. Chairman Buffington clarified that this was not a long-term policy by the EFIB.

Mr. Woodall asked Ms. Weaver if the Land Board could have made the decision that Mr. Haertzen had effectively made for them. Ms. Weaver answered, yes. Mr. Woodall asked if EFIB could go to the Land Board and ratify the decision to make the adjustment. Ms. Weaver replied yes.

Representative Deal suggested that a spreadsheet be prepared on what the real fiscal impact is going to be and then make the recommendation to the Land Board. There was further discussion about the time frame we're working with, in order to accommodate DFM's budget deadline of September 1. Mr. Woodall asked what the impact will be. Ms. Sugiyama answered by explaining the effect is on the earnings reserve balances. The earnings reserve accounts pay out all the distributions to the beneficiaries; and the primary revenue stream is the Lands revenue; the larger the buffer in the earnings reserve balances, the more comfortable that the EFIB and Land Board will feel in regard to the ability to pay out distributions. The effect has a difference on the earnings reserve balances. Mr. Taylor asked if we could submit this proposal to DFM, with a footnote, subject to the approval of the EFIB and Land Board. Ms. Weaver said that would be a problem. Ms. Weaver would like to avoid a failure to communicate and this raises that potential. The Board discussed other options to address this issue within the timeframe, while ensuring that they come to a fully informed decision.

Representative Deal was concerned that we know the fiscal impact to each of the beneficiaries prior to proposing a recommendation to the Land Board. Senator Little added that if the statutes clear that they make the decision, then they make the decision. And the EFIB is in charge of the investment part of it and while we make recommendations, that's the Land Board's constitutional charge. Sen. Little is concerned that nobody had this in their sights.

Chairman Buffington clarified the recommendation from Rep Deal and supported by Mr. Kealey, to have our staff put the proposals side by side and let the executive committee formulate the recommendation to present to the State Land Board. Ms. Sugiyama indicated that a breakdown was just completed and reviewed by Eide Bailly prior to the meeting and will send out the FY04 gain allocation breakdown later today. Mr. Lawrence indicated that this will not address what the future distribution will be; just the impact of what has happened. Chairman Buffington reiterated that this was a one time anomaly. The Land Board should be notified and be given the opportunity to accept this exception or restate. Mr. Lawrence asked if the distributions currently would work without restatement. Ms. Sugiyama indicated that with the restatement, the amount of the distribution would decrease slightly (decreasing the current market value to give to earnings reserve; the distributions paid by normal school would go down slightly because they are calculated on a 3-year moving average of the permanent value). Senator Little inquired as to the amount of the impact. Ms. Sugiyama said that the distribution would be less and the earnings reserve balance would increase. They reviewed the Normal Schools example and the impact on the earnings reserve account. An additional cushion is provided. Senator Little responded that this could be a significant cash flow issue – and that the Land Board is in charge of keeping a reasonable cash flow on all funds, including the smaller funds. Ms. Weaver clarified that the way it works is that the statutes direct EFIB how to allocate; here the EFIB did not allocate, and in essence made a transfer and only the Land Board directs transfers. In a normal year, transfers would not have happened. Mr. Haertzen failed to consider one particular statute. Ms. Weaver said that Mr. Haertzen misinterpreted the statutes, and most likely failed to consider it at all; believes we have to restate unless the Land Board wants to make a transfer.

Chairman Buffington and Senator Little agreed that based on the statute, we don't have a choice. Ms. Weaver said we should go to the Land Board and let them know that an error was made. She further advised that the Land Board does have the authority to make the transfer if they believe that that was the right policy decision. Ms. Weaver indicated that legally you don't have to have the Land Board decide, but that is an option. Ms. Sugiyama said that if we correct it, it will result in our restatement for 2004. Fortunately for 2005, we are in the middle of the audit process, and the gains have not been allocated yet. Chairman Buffington feels that it is better to let them know of the correction. Mr. Kealey agreed that it would be better to restate and footnote it. Ms. Weaver brought to attention, the timing and effective date of the statute and will check

the policies written (to verify the issue). Subsection 4 was rewritten in 2004; there were two items of legislation. Ms. Weaver left the room to review the statute.

Chairman Buffington asked that Item #3 Spending Policy be discussed.

3. 2007 Spending Policy Review

Ms. Sugiyama referred to the FY07 Spending Policy handout. This was presented at the pre-Land Board meeting earlier this morning. It is assumed that the payout is at 5%. A recommendation needs to be forwarded to the Land Board, reaffirming that the FY07 payout, for both public schools and pooled accounts, is 5%. It is understood that the Land Board makes all the policy decisions. Ms. Sugiyama noted we may need clarification on FY 2008 spending policy and going forward. While we did not want to tie the EFIB or Land Board into an assumed payout, DFM requested the distribution amounts to prepare the budgets which are due by September 1st, and to ensure that none of the earnings reserve balances will fall to zero. There are sufficient funds in the earnings reserve accounts for the payout of FY07 (with reasonable safety), provided the projections are accurate. She has checked to see if this is true for all the beneficiaries, and that they are able to make the payout. Senator Little asked if the payout for pooled accounts was at 7%. Ms. Sugiyama agreed and further explained the payout was going down in a decreasing scale for 2006 – 6%; 2007 - 5%; 4% - 2008, with a stability of 4% thereafter.

Chairman Buffington recalled that in 2001, a recommendation was made in regards to the reduction in those payouts. In November 2001, there was a luncheon meeting with the Governor, during which we agreed to not take the reduction payouts down as fast. Then, late last year or early this year, the discussion came up with the improvement in market value of securities, could we consider not taking the payout reductions as fast. Chairman Buffington did not recall any discussion this spring on a differentiation of public schools or pooled funds. Senator Little responded that one of the reasons on taking the reduction payouts, to attempt in getting the money built back up in the earnings reserve accounts. This goes back to our long term investment strategy. He would prefer that we develop steps in attaining an adequate return for the 5% payout. Chairman Buffington said that if we were to go back to what the original thought process was – it would be that the pooled funds go to 4% in 2008. Senator Little agreed. Mr. Woodall asked if there is time to work on the issue for FY08 at 4%. Ms. Sugiyama answered that we do not need to decide this now. This issue did come up at the pre-Land board meeting, regarding the long term spending policy. There are key considerations, including communication with the Land Board and EFIB, understanding the Land Board makes the determination on the spending policy.

Senator Little made a motion to stay with the current payout for this year – and study if we can go to 4% for next year. Ms. Sugiyama clarified that she will present to the Land Board that the EFIB is seeking reaffirmation of a 5% payout for public schools and pooled accounts. Representative Deal seconded. Mr. Kealey asked to confirm that there are no other minutes floating around that this was agreed to in the past. The motion was carried unanimously.

Ms. Sugiyama made another comment in regards to the spending policy: during the pre-Land board meeting, they asked what our recommendations were in addressing statute interpretations and long-term spending policy. We discussed a task force committee be formed to review these issues for the future. Chairman Buffington and Mr. Woodall voiced their support.

2. Ms. Weaver indicated she doesn't believe the change in 2004 alters the analysis presented. Chairman Buffington asked Ms. Weaver to read §57-720 subsection 4. *"Prior to the annual*

calculation of gains and losses pursuant to section 57-724, Idaho Code, the investment board shall allocate the end of fiscal year market value between the permanent endowment funds and the earnings reserve funds. This allocation shall be made based upon the proportion that the market value of the permanent endowment funds and the market value of the earnings reserve funds bear to the combined market value of both sets of funds, at the end of the fiscal year."

Mr. Woodall asked how this was a change prior to 2004 loss. Ms. Weaver answered that it didn't say "prior to the annual calculations of gains and losses"; it just read that "the Endowment Board shall annually allocated between the two". Representative Deal said that it also included the "Investment Board shall allocate" (no identification was made before of who was going to allocate). Ms. Weaver indicated that an emergency clause was done in March (which is done once a year), which affected part of the FY in 2004; and believes this does not affect our analysis. The allocation is based on the proportion that each represents of the total. Senator Little asked how does this match up to the position that if the Land Board makes policy, and EFIB doesn't do anything – even though it says that "we shall allocate". Is there any discretion in the new code section? Ms. Weaver said there is no discretion to the EFIB. She added that the section that denotes the Land Board can transfer is in 57-724.

Senator Little clarified that the new code section tells us what to do; there is no discretion. That when we get to a surplus or above the benchmark gain, then they (Lands Board) can make the decision of whether to transfer the excess to the earnings reserve or keep it to the permanent fund. Ms. Weaver said that they can transfer from earnings reserve to permanent while we are in a loss situation also. Rep Deal noted that 57-724 sub. 2a, is unchanged: *"(a) The state board of land commissioners may annually transfer any funds in the public school earnings reserve fund that it determines will not be needed for administrative costs..."*

Ms. Weaver said that in the main body of subsection 2, it notes the same effect for the other funds. Rep Deal asks that if the EFIB has the authority to allocate and it is noted that the commissioners may annually transfer irregardless, how the EFIB, through the MOI calculates the gain/loss, how is this changing? Ms. Weaver answered that there isn't a change. Ms. Weaver confirmed and reiterated that Endowment Fund does not have any discretion, but to allocate the way the statutes say. The Land Board can ratify what Mr. Haertzen did by approving a transfer. On the accounting side it will show that EFIB allocated according to the statute and the Land Board transferred it. That's what will have to happen because the EFIB doesn't have the authority to transfer between the earnings reserve and permanent.

Chairman Buffington stated that what the Endowment Fund did last year was incorrect – this needs to be ratified or changed. Mr. Woodall agrees and this discussion has clarified the rules that need to be followed, and split it between the two funds. It is apparent that we go to the Land Board and make note of what happened; with the option of ratifying or changing (restating) the decision now. Mr. Woodall suggested we be prepared to answer questions about the fiscal impact, per Representative Deal's previous comments.

Ms. Sugiyama was asked by Chairman Buffington if we are able to answer the questions that could come up by the Land Board. She confirmed that we will be prepared.

Mr. Woodall motioned that we will go to the Land Board meeting to discuss what happened in 2004, and provide them with the option of restating or ratifying the aforementioned issue. Senator Little seconded the motion, and the motion was carried unanimously. There was no further discussion.

Next Meeting Date – August 18, 2005 – 9:00 a.m.

- The next regular meeting of the Board will be August 18, 2005 at the EFIB office.
- Interviews for the MOI position will be held from 1:00 p.m. – 6:00 p.m. (1 hr. 15 minutes for each interview).
- Lunch will be ordered in.
- Staff will formally invite members of the Land Board, in addition to the State Insurance Fund (Jim Alcorn) and Judges (Corrie Keller), to meet the candidates and ask for their input.

Adjournment

There being no further business to come before the Board, by motion duly made by Mr. Woodall, seconded by Senator Little, and unanimously approved by members, the meeting adjourned at 3:17 p.m.